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SUBJECT: IRAQ'S PRIVATE BANKS ACCELERATE LENDING

¶1. SUMMARY: Iraq's private banks have dramatically accelerated lending since October 2008. Their total lending is now growing at an annual nominal rate of 80%, twice as fast as one year ago. Increasing public confidence and a recent capital infusion in private banks appear to be the main forces behind this trend. However, private banks are still reluctant to lend beyond what they have in capital reserves because Iraq's banking system lacks the credit infrastructure to provide financial intermediation services. Iraq still lacks a money market, credit bureaus, deposit insurance, and a system for recording liens. Left to their own devices, commercial banks will not create these institutions. (Note: The state-owned banks do not figure into the analysis in this cable. End note.) END SUMMARY.

LENDING TAKES OFF

¶2. Iraq's private banks have dramatically accelerated their lending since last fall. According to Central Bank of Iraq (CBI) data, total lending by private banks grew at an annual nominal rate of 80% between October 2008 and March 2009. This is more than twice as fast as that of the period from January through September 2008, when lending grew at an annualized rate of 38%. As of March 2009, private banks held 27% of all loans in the banking system, worth approximately \$1.18 billion. Iraqi-owned private banks, which make up 82% of the private market, increased their lending by 49% since October 2008, which is particularly noteworthy. In contrast, foreign-owned banks which hold the remaining 18% of the private market only increased their lending by 7%.

INCREASED CONFIDENCE AND CAPITAL

¶3. Just like lending, deposits in private banks increased significantly. Between January 2008 and March 2009, private banks' share of total deposits rose from 8% percent to 12% percent, or by \$1.65 billion. This indicates the Iraqi public is overcoming its mistrust of the private banks by opening new accounts and subsequently applying for new loans.

¶4. Concurrent to this rise in confidence, private banks greatly increased their capital reserves during this same period. From January 2008 through March 2009, private bank capital rose by 37%, or \$368 million. Because Iraq has no deposit insurance system, private banks in Iraq have prudently kept their loans to below capital levels, thereby minimizing risk for depositors. These banks have an average return on equity of 44%, which primarily consists of earnings on fees and commissions rather than the interest margin. The impressive increase in capital during this period appears to underpin the growth in private bank lending.

BUT BANKS ARE STILL CONSERVATIVE

¶5. As the dramatic lending increase chiefly came from banks'

newfound capital during this period and not from new deposits, banks remain generally quite conservative in their lending policies. In January 2008, the private bank ratio of loans to deposits was just 32%, far below the typical ratio seen in a well developed banking system (over 90% in the United States). In March 2009, the banks' loan-to-deposit ratio was 31%, effectively unchanged from the year before, despite the dramatic growth of lending during the same period. Risk-adverse private banks are still not ready to provide the financial intermediation services needed to modernize Iraq's economy and fuel private-sector expansion.

¶6. The banks' consistently low ratio of loans to deposits reflects that they have plenty of money to lend. While many businesses in Iraq have excellent prospects for growth, it remains extremely difficult for bankers to differentiate between good and bad lending risks. The banks also lack confidence in a given loan applicant repaying a loan. Perceived risk, not the interest rate, is the fundamental impediment to lending. The threadbare network of relationships between the banks and potentially eligible business borrowers is one of the most important constraints on the flow of credit within Iraq's economy.

GAPS IN CREDIT INFRASTRUCTURE CONSTRAIN BANKS

¶7. Better business relationships are just one element of the remedy. Equally urgent is building the credit infrastructure Iraq still lacks. Six years into Iraq's post-Saddam history, the country still has no money market and therefore no public signals on the price of credit. No credit bureau exists to give banks reliable information on the riskiness of individual borrowers. Moreover, Iraq lacks a system for recording liens, leaving banks with few ways of securing

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claims against borrowers. Banks have devised other ways to create security interests in collateral, but they are not practices used in modern bank lending. To use real estate as security for a loan, a borrower must typically transfer formal ownership of the property to the bank. But even this extreme practice leaves banks with significant risks because public records are incomplete or corrupted by Saddam-era illegal property transfers.

COMMENT

¶8. Although private banks are lending, the weak infrastructure for lending -- particularly related to collateral, a system for recording liens, credit ratings, and deposit insurance -- contributes to keeping them conservative. The commercial banks cannot create these institutions. These gaps in credit infrastructure are a problem not just for Iraqi entrepreneurs, but also impede foreign investment. Foreign firms interested in doing business in Iraq may find that they cannot secure financing from their home-country banks because of the absence of legal means of mitigating risks inside Iraq. END COMMENT.

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